KMC TELECOM HOLDINGS INC

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO
SECTIONS 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

(MARK ONE)
|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1999

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 333-50475

KMC TELECOM HOLDINGS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE 22-3545325

(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)
(I.R.S. EMPLOYER IDENTIFICATION NO.)

1545 ROUTE 206, SUITE 300
BEDMINSTER, NEW JERSEY 07921
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

Registrant's telephone number, including area code: (908) 470-2100

SECURITIES REGISTERED PURSUANT TO SECTION
12(B) OF THE ACT:
None

SECURITIES REGISTERED PURSUANT TO SECTION
12(G) OF THE ACT:
None

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. [X] Yes [ ] No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [X].

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of March 29, 2000 was approximately $69,982,563, based upon an estimate of the fair value thereof by management of the registrant. There is no established trading market for the voting common stock of the registrant and no sales have occurred within the past sixty days.

As of March 29, 2000, 853,765 shares of the registrant's Common Stock, $0.01 par value, were outstanding. There is no established trading market for the Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE. None.

CAUTIONARY STATEMENT REGARDING FORWARD - LOOKING STATEMENTS

STATEMENTS IN THIS ANNUAL REPORT ON FORM 10-K THAT ARE NOT PURELY HISTORICAL ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, INCLUDING STATEMENTS REGARDING THE COMPANY'S EXPECTATIONS, HOPES, INTENTIONS OR STRATEGIES REGARDING THE FUTURE. FORWARD-LOOKING STATEMENTS INCLUDE: STATEMENTS REGARDING THE ANTICIPATED DEVELOPMENT AND EXPANSION OF OUR BUSINESS, THE MARKETS IN WHICH OUR SERVICES ARE CURRENTLY OFFERED, OR WILL BE OFFERED IN THE FUTURE, ANTICIPATED CAPITAL EXPENDITURES AND REGULATORY REFORM, THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF THE COMPANY, OUR DIRECTORS OR OFFICERS WITH RESPECT TO OUR FUTURE FINANCIAL PERFORMANCE AND OTHER MATTERS, AND OTHER STATEMENTS REGARDING MATTERS THAT ARE NOT HISTORICAL FACTS. ALL FORWARD-LOOKING STATEMENTS IN THIS REPORT ARE BASED ON INFORMATION AVAILABLE TO THE COMPANY AS OF THE DATE THIS REPORT IS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION, AND THE COMPANY ASSUMES NO OBLIGATION TO UPDATE ANY SUCH FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THE FACTORS SET FORTH IN "ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS -- CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS."

PART I

ITEM 1. BUSINESS.

BACKGROUND

The initial predecessors of KMC Telecom Holdings, Inc. were founded in 1994 and 1995, respectively, by Harold N. Kamine, the Company's Chairman of the Board. These predecessors were merged in 1996 and renamed KMC Telecom Inc. KMC Telecom Holdings, Inc. was formed during 1997 primarily to own, directly or indirectly, all of the shares of its operating subsidiaries, KMC Telecom Inc., KMC Telecom II, Inc., KMC Telecom III, Inc., and KMC Telecom of Virginia, Inc. The principal equity investors in the Company currently include Mr. Kamine, Nassau Capital Partners, L.P., Newcourt Capital, Inc., First Union Corp., General Electric Capital Corporation and Lucent Technologies, Inc.

COMPANY OVERVIEW

We are a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III markets (markets with a population from 100,000 to 750,000). A facilities-based competitive local exchange carrier is one which operates its own network, including switching equipment and transmission lines, rather than one which intends to primarily resell the services of other carriers. The markets in which we operate are predominantly located in the Southeastern and Midwestern United States. We target as customers business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless service providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, Internet access infrastructure, ISDN (or integrated services digital network), long distance, special access, private line and a variety of other advanced services and features.

We currently operate in 34 Tier III markets and have systems under

construction in 3 additional Tier III markets. We expect these new systems to be commercially operational by the end of the first half of 2000. During 2000 we will continue to investigate new Tier III markets. We construct robust fiber optic networks in each of our markets, which we believe allows us to ensure high quality of service, facilitate the delivery of value-added and data services, and effectively control our costs. We currently have Lucent Technologies Series 5ESS(R)-type switches in commercial operation in all of our operational markets and intend to install Lucent switches in any future networks which we may build.

BUSINESS STRATEGY

We intend to become the dominant competitive provider of telephony and data services in the markets that we serve. To accomplish this objective we intend to:

Focus on Tier III markets. We intend to operate in Tier III markets with attractive demographic, economic, competitive and demand characteristics. We believe that incumbent local exchange carriers tend to focus their efforts on larger markets and generally underserve and underinvest in Tier III markets. We also believe that there is generally significantly less competition from other facilities-based competitive local exchange carriers in Tier III markets, which allows us to gain market share more rapidly than we could expect in Tier I and Tier II markets. In addition, network construction, labor and rights-of-way costs are generally lower in Tier III markets than in Tier I and Tier II markets. For example, many Tier III markets permit significant aerial deployment of fiber optic cable which is less expensive than the buried deployment required in many Tier I and Tier II markets. We estimate that approximately 70% of our fiber is deployed aerially. We select target markets from among the approximately 250 Tier III markets in the United States by first identifying those markets that do not yet have significant, established competitors to the existing incumbent local exchange carrier, and by then reviewing the specific demographic, economic, competitive and telecommunications demand characteristics of such markets to determine their suitability for the types of services which we offer. We estimate market demand on the basis of the concentration of potential business, government and institutional end-user customers in the market and the general economic prospects for the area.

Deploy comprehensive fiber networks. We build geographically extensive, full service, facilities-based networks. We believe such networks provide significant operating leverage, facilitate the capture of market share, and are likely to deter other competitive local exchange carriers from attempting to penetrate our markets due to the cost of constructing a competing network of equal capability. Prior to both the initial construction of our network backbone and any subsequent network expansion, we perform detailed rate of return analyses to justify the capital expenditures involved. In all of our operational markets, we have completed our backbone construction connecting the market's central business district with outlying office parks, large institutions, the locations of long distance carriers' transmission equipment and major incumbent local exchange carrier central offices. We intend to continue to expand our existing networks in response to anticipated customer demand.

Provide enabling infrastructure for data services growth. We intend to serve as a gateway for the provision of sophisticated value-added data services and high speed connectivity to customers in Tier III markets. We believe it is strategically important for us to offer these services because:

data and internet access is required for businesses to succeed and grow,

e-commerce is mission critical for many businesses, and

national service carriers and internet service providers, such as Qwest and UUNet feel it is necessary for them to expand into Tier III markets.

will provide data services directly to our own customers and will also provide access to Tier III markets for long distance carriers, national service carriers, Internet service providers and other businesses which require broadband access to those markets but which have not constructed their own networks and connections in those markets to enable them to provide it to their

own customers.

Establish local presence with personalized customer service. We seek to capture and retain our retail customers through local, personalized sales, marketing and customer service programs. To this end, we:

- o establish sales offices in each market in which we operate a network,
- o strive to recruit our city directors and sales staff from the local market,
- o rely principally on a face-to-face selling approach, and
- o support our sales staff with locally based customer service and technical support personnel.

Most of our existing sales personnel are local residents who have previously worked for the incumbent local exchange carrier or other telecommunications companies. We believe that our "Creative Solutions with a

Hometown Touch"(R) sales approach is very important to customers in Tier III markets, who do not typically receive focused local sales contact or customer support from the incumbent local exchange carrier. We seek to build long-term relationships with our customers by responding rapidly and creatively to their telecommunications needs.

Employ a national approach to larger accounts. While establishing a local presence to market to retail customers in our markets, we will employ a national approach to large wholesale customers, such as long distance carriers and Internet service providers, through our carrier group and to the headquarters of large corporations with branch offices in our markets through our national accounts sales organization.

Deploy networks rapidly. It is our practice to use innovative "switch-in-a-box" construction and deployment techniques for most of our networks. Using these techniques, transmission, switching and power equipment are pre-installed by Lucent under controlled factory conditions in portable, weatherproof, storm-proof concrete buildings delivered to the Lucent facility by our contractor. The completed buildings are then shipped to the appropriate city for final installation, reducing costs, installation risks and time to market.

Implement a high-quality operations support system. We are developing a high-quality operations support system to provide us with comprehensive billing, order processing and customer care software for all of our existing and contemplated services. This system is designed to provide us with a single "flow-through" order form that will entail several components, allowing each order to be tracked from service provisioning through to complete installation. We believe that this system will allow us to quickly address customer concerns and provide us with a competitive advantage in customer service and operations efficiency. Initial installation of the new operational support systems commenced during the third quarter of 1999, with development and expansion to continue over the next 12 months.

Leverage our experienced management team. Our experienced management team is led by Harold N. Kamine, Chairman of the Board of Directors. Other members of the team include Roscoe C. Young II, President and Chief Operating Officer, William H. Stewart, Executive Vice President and Chief Financial Officer, Tricia Breckenridge, Executive Vice President--Business Development and James L. Barwick, Senior Vice President and Chief Technology Officer.

SERVICES

General. We have historically provided dedicated access service and have also resold switched services which we purchased from incumbent local exchange carriers. In December 1997, we began providing our own on-net switched services to our customers via direct connections to our networks or unbundled network elements leased from incumbent local exchange carriers. On-net switched services and resale services have accounted for the following percentages of our revenues

in 1997, 1998 and 1999:

	1997	1998	1999
On-net switched services.....	32%	37%	69%
Resale services.....	68%	63%	31%

Private Line and Special Access Services. We currently provide various types of on-net dedicated services which permit the transmission of voice and data between two points over circuits dedicated to a particular customer. Private line service involves the provision of a private, dedicated telecommunications connection of a customer's different locations. For these services we offer several types of dedicated circuits that have different capacities. DS-1 and DS-3 circuits are dedicated lines that can carry up to 24 and 672 DS-0 circuits, respectively. Special access service involves leasing private, dedicated telecommunications lines running over our networks to long distance carriers. The long distance carriers use these lines to connect different locations where they have installed transmission equipment within the market, to connect locations where they have installed transmission equipment to the transmission equipment locations of other long distance carriers within the market, or to connect large customers directly to the locations of their transmission equipment. In addition to DS-0, DS-1 and DS-3 dedicated circuits, we also offer OC3, OC12 and OC48 circuits for these services. These OC circuits provide the fastest transmission available for carriers and large business users.

Switch-Based Services. We have added and continue to add capability to provide local dial tone and switched access origination and termination services to our networks. Switches are currently in commercial operation in all of our 34 existing markets and we expect switches to be in commercial operation in the 3 additional Tier III markets in which we currently have networks under construction by the end of the first half of 2000.

Long Distance. We offer a full range of long distance products including inter-LATA, intra-LATA, interstate, international, calling card and 800-number services. During the first quarter of 1999, we introduced KMC-branded operator services, directory services, prepaid phone cards and audio-conference services. We offer these services both on-net and off-net. We offer long distance services on a resale basis by entering into wholesale agreements with various long distance carriers to deliver these services. We believe that many of our customers will prefer the option of purchasing long distance services from us as part of a one-stop telecommunications solution.

Centrex-type Services. We provide Centrex-type services. By using Centrex-type services instead of purchasing and installing a switching system on its own premises, a customer can substantially reduce its capital expenditures and the fixed costs associated with maintaining telecommunications equipment. We introduced our ClearStarsm Advantage service in all of our operational markets during the first quarter of 1999. It has been designed to support multiple applications, ranging from basic access services to services focused on desktop applications. The basic access service connects to a customer's internal system and is equipped with up to 14 features including call forwarding, speed dialing and call transfer capabilities. More sophisticated levels of service are designed to replace portions of a customer's existing telecommunications system. At the high end of service offerings is ClearStarsm Advantage Plus, a packaged, end-to-end offering which combines all of the basic features with Basic Rate ISDN network access, advanced feature functionality, voice messaging and Lucent ISDN multi-featured telephone sets.

New Data Services Offerings. Data services represented approximately 9% of our revenue for 1999. We currently plan to expand our capabilities by introducing additional data services in 2000. We believe that these services will enhance our ability to provide an integrated turnkey solution to our customers' voice, data and video transmission requirements. These data services will include:

- Basic Rate ISDN. Basic Rate ISDN, or BRI, provides customers the

potential of 144 kilobits per second of digital communications via a single network facility interface. We believe it will be attractive to small and medium size customers, since it provides dial-up access to the Internet, and other dial-up data applications, while simultaneously providing the ability to integrate voice traffic on a single network facility.

- Primary Rate ISDN. Primary Rate ISDN provides customers the equivalent of 1.544 megabits per second of digital communications via a T-1 type facility, with 23 channels for voice and data communications and a 24th channel providing network signaling and control for the services. We focus our Primary Rate ISDN sales efforts on (i) Internet service providers who use Primary Rate ISDN as a means of supporting customer access to their operations, and (ii) end-user customers who use Primary Rate ISDN as a network access facility for their internal telecommunications systems.

- Port wholesale. Port wholesaling is a technology that provides large bandwidth users with data switching capability at the network level, allowing them to acquire capacity as required without investing in data switching equipment. Port wholesaling gives us the ability to provide data switching to Internet service providers by allowing data calls to be terminated through the port wholesale equipment rather than the switch. This enables the Internet service provider to more cost effectively manage its data requirements while, at the same time, increasing the efficiency and capacity of our Lucent Technologies Series 5ESS(R)-type switch.

- DSL. DSL is a method of using unconditioned, copper wire pairs for high bit-rate data transport for use in the "last mile" connecting our network backbone ring to the customer's premises. We plan to utilize DSL to provide high bandwidth data and video service to small and medium size customers.

- Frame Relay/ATM. Frame relay and ATM, or asynchronous transfer mode, are used by some of our data customers as a fast data transport service for Wide Area Networks. Today we resell these services. In the future we intend to provide these services over our own network and utilize a third party provider for transport outside our network.

We plan to remain flexible in responding to evolving customer demands for data services.

LOCAL NETWORKS

As part of determining the economic viability of a network in a particular market, we review the demographic, economic, competitive and telecommunications demand characteristics of the market. We estimate market demand using data gathered from long distance carriers, the Federal Communications Commission, local sources, site visits and specific market studies commissioned by us, the concentration of potential business, government and institutional end-user customers and the general economic prospects for the area.

Once we target a market for development, we design a network to provide access to approximately 70% of the business customers in that market either through direct connections to our network or through unbundled network elements leased from the incumbent local exchange carrier. Typically, we construct a "self-healing" synchronous optical network ("SONET") architecture backbone ring to provide coverage of the major business districts, government offices, hospitals, office parks and universities, the principal locations of the transmission equipment of long distance carriers offering services in the area, and the incumbent local exchange carrier's central office(s). Following construction of our backbone network, we expect to build additional loops to increase the size of our addressable market, as required.

During Phase I of our network construction program we completed networks in 8 Tier III markets. We established networks in 15 Tier III markets during Phase II of the program and will add networks in 14 additional Tier III markets during

Phase III. Eleven of the 14 networks to be added during Phase III have been completed and the remaining 3 networks will be completed during the first half of 2000. The markets in which we established or plan to establish markets during each of these phases of the program are as follows:

PHASE I	PHASE II	PHASE III
Huntsville, Alabama	Greensboro, North Carolina	Charleston, South Carolina
Baton Rouge, Louisiana	Winston-Salem, North Carolina	Lansing, Michigan
Shreveport, Louisiana	Tallahassee, Florida	Akron, Ohio
Corpus Christi, Texas	Roanoke, Virginia	Spartanburg, South Carolina
Savannah, Georgia	Ann Arbor, Michigan	Toledo, Ohio
Madison, Wisconsin	Topeka, Kansas	Columbia, South Carolina
Augusta, Georgia	Fort Wayne, Indiana	Monroe, Louisiana
Melbourne, Florida	Eden Prairie, Minnesota	Montgomery,Alabama
	Daytona Beach, Florida	Clearwater/St.Petersburg, Florida
	Fort Myers, Florida	Dayton, Ohio
	Longview, Texas	Biloxi/Gulf Port, Mississippi
	Sarasota, Florida	Johnson City/Kingsport, Tennessee
	Pensacola, Florida	Chattanooga, Tennessee
	Fayetteville, North Carolina	
	Rockville/Bethesda/Frederick, Maryland	
	Norfolk, Virginia	

The following table presents aggregate data as of February 29, 2000, for the networks placed in operation during Phase I and Phase II, respectively, of our network construction program:

	SWITCHED ACCESS LINES IN SERVICE(1)	DEDICATED DS-0 EQUIVALENT CIRCUITS IN SERVICE(2)	ROUTE MILES	ADDRESSABLE COMMERCIAL BUILDINGS(3)	CENTRAL OFFICE COLLOCATIONS
Phase I markets (8 markets)	65,396	136,572	662	14,800	33
Phase II markets (15 markets)	65,342	130,626	757	25,947	52
Total	130,738	267,198	1,419	40,747	85

(1) Represents all active switched channels we provide to customers either by resale via the incumbent local exchange carrier's network, by unbundled network elements leased from the incumbent local exchange carrier, or by direct connection to our own network.
(2) Represents all active dedicated DS-0, DS-1 and DS-3 circuits we provide to customers expressed on a DS-0 basis.
(3) Addressable by either unbundled network elements leased from the incumbent local exchange carrier or by a direct connection to our own network. We define a commercial building as one with greater than ten employees.

We are continuing to investigate expanding into additional Tier III markets during 2000. Further expansion of our networks, however, will be dependent upon our ability to obtain additional financing.

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically the subject of non-exclusive agreements of finite duration providing for the payment of fees by us or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are typically provided under non-exclusive multi-year agreements, which generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996 requires most utilities to afford access to rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates. However, there can be no assurance that delays or disputes will not occur. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence) of the other party.

Our requirements for a planned network are communicated to our engineering group which finalizes the route and completes the network's design. Independent construction and installation contractors are selected through a competitive bidding process. Our own personnel negotiate required contracts and rights-of-way and supervise the construction, installation and testing of network components prior to commencing commercial service. Cable, equipment and supplies required for the networks are available from a variety of sources at competitive rates. The construction period for a new network varies depending upon such factors as the number of backbone route miles to be installed, the relative use of aerial as opposed to buried cable deployment, the initial number of buildings targeted for connection to the network backbone and other factors. Based upon our experience, we believe that a new fiber optic network can be made commercially operational within approximately 6 months after construction commences.

In a typical Tier III market, selected office buildings are connected to our network by network backbone extensions or unbundled network elements leased from the incumbent local exchange carrier. Within each building, customer equipment is connected to Company-provided electronic equipment where customer transmissions are digitized, combined and converted to an optical signal. The traffic is then transmitted through the network backbone to our local central office where it can be routed to its ultimate destination.

We are able to expand our reach in a market by collocating equipment in an incumbent local exchange carrier's central office and leasing unbundled network elements from that incumbent local exchange carrier in order to reach customers located in buildings which are not directly connected to our own backbone ring. We attempt to place collocation equipment in a sufficient number of incumbent local exchange carrier central offices to allow us to reach approximately 70% of the business customers in a given market, either by means of such unbundled network elements or direct connections to our own network. The decision as to

whether to collocate in a specific central office is based upon the number of business lines, number and type of businesses, number of households and the location of the central office within the market.

Our networks consist of our fiber optic backbones, fiber laterals and unbundled network elements. Our networks allow for high speed, high quality transmission of voice, data and video communications. We typically install backbone fiber optic cables containing 48 to 144 fiber strands which have significantly greater bandwidth carrying capacity than other media. Our OC-48 SONET networks support up to 32,256 simultaneous voice conversations over a single pair of fiber optic fibers. We expect that continuing developments in compression technology and multiplexing equipment will increase the capacity of each fiber, thereby providing more bandwidth carrying capacity at relatively low incremental costs.

We currently offer end-to-end fully protected fiber services utilizing SONET ring architecture which routes customer traffic simultaneously in both directions around the ring to provide protection against fiber cuts. If a line is cut, traffic can simply be reversed and sent to its destination around the

other side of the ring. Back-up electronics become operational in the event of failure of the primary components.

We monitor our fiber optic networks and electronics seven days per week, 24 hours per day, using a combination of local and national network control centers. Local network monitoring is accomplished by means of an automatic notification system that monitors for any system anomaly. This system provides instantaneous alarms to an on-call network technician whenever an anomaly is detected. The local market technician is trained in network problem resolution and provides on-site corrective procedures when appropriate. A national Network Reliability Center, located in Denver, Colorado, acts as the focal point for all of our operating networks, providing integrated and centralized network monitoring, and correlation and problem management. The Network Reliability Center has access to all operating networks and can work independently of the local systems to effect repair or restoration activities. The Network Reliability Center is currently provided by Lucent on a contractual basis. In the future, we may develop our own national center.

We manage our network systems both locally and centrally. Customer service calls and maintenance are primarily handled through the local offices. In addition, as described above, we contract to provide integrated monitoring of our networks via Lucent's Network Reliability Center. This is accomplished by the use of a sophisticated integrated management system that is connected to all of our locations, including our Duluth, Georgia, operations center. With this system the Network Reliability Center is capable of accessing all available information regarding the configuration and operating condition of any network components in use. This proactive monitoring capability is further augmented by a 24 hour a day, seven day a week call center, also provided by Lucent at the Network Reliability Center, that receives, tracks and manages all customer calls and issues to satisfactory conclusion. The call center works with the Company's own customer care representatives and engineers in the Duluth facility to ensure that timely and consistent service is provided.

SALES AND MARKETING

We target our sales and marketing activities at three separate customer groups: retail, national accounts and wholesale. Retail customers are composed of business, government and institutional telecommunications and data services end-users and local Internet service providers. National accounts are usually large corporations which have branches or local offices within our markets, but which make their buying decisions centrally from their corporate headquarters. Wholesale customers typically consist of long distance carriers, wireless service providers and national Internet service providers. As of February 29, 2000, we had approximately 290 employees engaged in sales and marketing activities.

Retail Customers. We target retail customer segments such as business, government, healthcare and educational institutions. We target all business customers in our markets as well as local Internet service providers. Each city's local sales staff is responsible for calling on the retail customers in its market.

National Accounts. While there are few Fortune 500 companies with headquarters located in our operating cities, there are branches and local offices of large corporations within our market areas. Often these large corporations make their buying decisions centrally, either through their telecommunications or MIS functions, which are normally located at corporate headquarters. Our national accounts sales organization is structured to assist them in determining requirements for their various locations within our markets.

We believe that this focus on national accounts will further increase our market penetration with large companies in our cities.

Wholesale Customers. We currently target the major long distance carriers such as AT&T, MCI WorldCom and Sprint, Internet service providers, wireless service providers and other competitive local exchange carriers, through our carrier group. We believe that we can effectively compete to provide access to

these customers based on price, reliability, technology, route diversity, ease-of-ordering and customer service. We provide competitive pricing for the transport and termination of communications for high volume users of long-distance services, which has historically been provided by the incumbent local exchange carrier. To the extent that incumbent local exchange carriers begin to compete with long distance carriers in providing long distance services, the long distance carriers have a competitive incentive to move traffic away from incumbent local exchange carriers to competitive local exchange carriers like us. Wireless service providers, who need network backbone to transport calls, are an active customer base, as are other competitive local exchange carriers as wholesale users. Revenues from access services may decline in future years due to a change in pricing proposed by the Federal Communications Commission.

Sales Personnel. We establish local sales offices in each market that we serve. Initially, each local sales office is staffed by a City Director and 2 or 3 salespersons, which increases to between 4 and 6 as our operations in the market expand. We seek to hire our sales personnel locally, since we believe that knowledge of, and contacts in, a local market are key factors for competitive differentiation and commercial success in a Tier III market. We believe that this local focus will help to set us apart from the incumbent local exchange carriers, our principal competitors.

City Directors. We seek to hire local, seasoned telecommunications managers, with sales experience, as City Directors. City Directors assist with the initial network buildout and oversee the daily operations of their network, in addition to managing sales staff and market development. Daily operations responsibilities include monitoring provisioning, customer service, pricing decisions and the billing process. A City Director works with senior management in the strategic planning process, including capital expenditures and budget planning. They perform cash flow analysis for fiber connections of new buildings to the network, and participate in planning fiber network extensions in their markets.

SUPPLIERS

Lucent. We have contracted with Lucent, as our primary supplier, to purchase switching, transport and digital cross connect products. Lucent has also agreed to implement and test our switches and related equipment. In addition, Lucent and the Company have entered into an agreement pursuant to which Lucent has agreed to monitor our switches on an on-going basis. Lucent is an investor in our preferred stock and a lender under our Amended Senior Secured Credit Facility.

Billing Support Systems Implementation. In the second quarter of 1999, we installed software developed by Billing Concepts Systems, Inc. to provide us with comprehensive billing functionality, including the ability to collect call detail records, message rating, bill calculation, invoice generation, commission tracking, customer care and inquiry, collections management, and quality assurance. The Billing Concepts software enables us to produce a single bill covering all of the products and services that we provide to a customer. Additional development of the new billing systems will take place over the next 9 months.

Operational Support Systems Implementation. We entered into an agreement with Eftia OSS Solutions Inc. to develop operational support systems. These systems manage service order processing, circuit and asset inventory, telephone number inventory and trouble administration. The operational support system's responsibilities will be expanded during the later phases of the project to include workforce management, local number portability management, network management, service bureau interfaces, and Internet-based service inquiry. The system will automate operational support activities and provide a means of managing operational performance of our business. Initial installation of the new operational support systems commenced during the third quarter of 1999, with development and expansion to continue over the next 12 months.

COMPETITION

Overview. The telecommunications industry is highly competitive. Our principal competitors in Tier III markets will be the incumbent local exchange carriers. In most instances the incumbent local exchange carrier is one of the Regional Bell Operating Companies (such as Ameritech, Bell Atlantic, BellSouth or SBC), one of GTE Corporation's subsidiaries or one of Sprint Corporation's subsidiaries. Incumbent local exchange carriers presently have almost 100% of the market share in those areas we consider our market areas. Because of their relatively small size, we do not believe that Tier III markets can profitably support more than two competitors to the incumbent local exchange carrier.

Other competitors may include other competitive local exchange carriers, microwave and satellite carriers, wireless telecommunications providers and private networks built by large end-users. Potential competitors (using similar or different technologies) include cable television companies, utilities and Regional Bell Operating Companies seeking to operate outside their current local service areas. In addition, there may be future competition from large long distance carriers, such as AT&T and MCI WorldCom, which have begun to offer integrated local and long distance telecommunications services. AT&T also has announced its intention to offer local services using a new wireless technology. Consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors to the Company.

Both the long distance business and the data transmission business are extremely competitive. Prices in both businesses have declined significantly in recent years and are expected to continue to decline. In the long distance business, we will face competition from large carriers such as AT&T, MCI WorldCom and Sprint. We will rely on other carriers to provide transmission and termination for our long distance traffic and therefore will be dependent on such carriers.

Incumbent Local Exchange Carriers. Our principal competitors for local exchange services are the Regional Bell Operating Companies, GTE Corporation's subsidiaries and Sprint Corporation's subsidiaries. As a recent entrant in the integrated telecommunications services industry, we have not yet achieved a significant market share for any of our services. In particular, the incumbent local exchange carriers: have long-standing relationships with their customers,

- have financial, technical and marketing resources substantially greater than ours,
- have the potential to fund competitive services with revenues from a variety of businesses, and
- currently benefit from certain existing regulations that favor the incumbent local exchange carriers over us in certain respects.

Recent regulatory initiatives allow us, as a competitive local exchange carrier, to interconnect with incumbent local exchange carrier facilities. This provides increased business opportunities for us. However, these regulatory initiatives have been accompanied by increased pricing flexibility for, and relaxation of regulatory oversight of, the incumbent local exchange carriers. If the incumbent local exchange carriers engage in increased volume and discount pricing practices or charge us increased fees for interconnection to their networks, or if the incumbent local exchange carriers seek to delay implementation of our interconnection to their networks, our business, financial condition and results of operations could be adversely affected.

To the extent that we interconnect with and use incumbent local exchange carrier networks to serve our customers, we are dependent upon their technology and capabilities. We will become increasingly dependent on interconnection with incumbent local exchange carriers as switched services become a greater percentage of our business. The Telecommunications Act of 1996 imposes interconnection obligations on incumbent local exchange carriers, but we cannot assure you that we will be able to obtain the interconnection we require at rates, and on terms and conditions, that will permit us to offer switched services at desirable rates, terms and conditions. In the event that we experience difficulties in obtaining appropriate and reasonably priced service from the incumbent local exchange carriers, our ability to serve our customers would be impaired.

Competitive Local Exchange Carriers and Other Competitors. We will compete from time to time with other competitive local exchange carriers. It is likely that in several of our markets we will face competition from two or more facilities-based competitive local exchange carriers. After the investment and expense of establishing a network and support services in a given market, the marginal cost of carrying an additional call is negligible. Accordingly, in Tier III markets where there are 3 or more facilities-based competitive local exchange carriers, we expect substantial price competition. We believe that operations in such markets are likely to be unprofitable for one or more operators.

We expect to face competition in each of our markets. However, we believe that our commitment to build a significant network, deploy switches and establish local sales and support facilities at the outset in each of the Tier III markets which we target should reduce the number of facilities-based competitors and drive other entrants to focus on the resale of incumbent local exchange carrier service or our services or to invest in other markets. We believe that each market will also see more agent and distributor resale initiatives.

We expect to experience declining prices and increasing price competition. We cannot assure you that we will be able to achieve or maintain adequate market share or revenue, or compete effectively, in any of our markets.

REGULATION

Our services are subject to varying degrees of federal, state and local regulation. The Federal Communications Commission exercises jurisdiction over facilities of, and interstate and international services offered by, telecommunications common carriers. The state regulatory commissions retain jurisdiction over the same facilities and services to the extent they are used to originate or terminate intrastate communications. Local governments sometimes impose franchise or licensing requirements on competitive local exchange carriers.

Federal Regulation

We are regulated at the federal level as a nondominant common carrier subject to minimal regulation under Title II of the Communications Act of 1934. The Communications Act of 1934 was substantially amended by the Telecommunications Act of 1996. This legislation is designed to enhance competition in the local telecommunications marketplace by:

- removing state and local entry barriers,
- requiring incumbent local exchange carriers to provide interconnection to their facilities,
- facilitating the end-users' choice to switch service providers from incumbent local exchange carriers to competitive local exchange carriers such as the Company, and
- requiring access to rights-of-way.

The legislation also is designed to enhance the competitive position of the competitive local exchange carriers and increase local competition by newer competitors such as long distance carriers, cable television companies and public utility companies. Under the Telecommunications Act of 1996, Regional Bell Operating Companies have the opportunity to provide in-region long distance services if certain conditions are met and are no longer prohibited from providing certain cable television services. In addition, the Telecommunications Act of 1996 eliminates certain restrictions on utility holding companies, thus clearing the way for them to diversify into telecommunications services.

The Telecommunications Act of 1996 specifically requires all telecommunications carriers (including incumbent local exchange carriers and competitive local exchange carriers (like us)):

- not to prohibit or unduly restrict resale of their services,
- to provide dialing parity and nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listings,

- to afford access to poles, ducts, conduits and rights-of-way, and
- to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

It also requires competitive local exchange carriers and incumbent local exchange carriers to provide interconnection for the transmission and routing of telephone exchange service and exchange access. It requires incumbent local exchange carriers to provide such interconnection:

- at any technically feasible point within the incumbent local exchange carrier's network,
- that is at least equal in quality to that provided by the incumbent local exchange carrier to itself, its affiliates or any other party to which the incumbent local exchange carrier provides interconnection, and
- at rates, terms and conditions that are just, reasonable and nondiscriminatory.

Incumbent local exchange carriers also are required under the new law to provide nondiscriminatory access to network elements on an unbundled basis at any technically feasible point, to offer their local telephone services for resale at wholesale rates, and to facilitate collocation of equipment necessary for competitors to interconnect with or access the unbundled network elements.

The Telecommunications Act of 1996 provided for the removal of most restrictions from AT&T and the Regional Bell Operating Companies resulting from the consent decree entered in 1982 providing for divestiture of the Regional Bell Operating Companies from AT&T in 1984. The Telecommunications Act establishes procedures under which a Regional Bell Operating Company can enter the market for long distance service between specified areas within its local service area. The Telecommunications Act of 1996 permitted the Regional Bell Operating Companies to enter the out-of-region long distance market immediately upon enactment, and Regional Bell Operating Companies can provide intra-LATA long distance services. Before the Regional Bell Operating Company can provide in-region inter-LATA services, it must obtain Federal Communications Commission approval upon a showing that facilities-based competition is present in its market, that the Regional Bell Operating Company has entered into interconnection agreements in the states where it seeks authority, that the Regional Bell Operating Company has satisfied a 14-point "checklist" of competitive requirements, and that such entry is in the public interest. To date, the Federal Communications Commission has granted such authority only to Bell Atlantic in New York State. The provision of inter-LATA services by Regional Bell Operating Companies is expected to reduce the market share of major long distance carriers, and consequently, may have an adverse effect on the ability of competitive local exchange carriers to generate access revenues from the long distance carriers.

Federal Communications Commission Rules Implementing the Local Competition Provisions of the Telecommunications Act of 1996. The Federal Communications Commission in 1996 established a framework of national rules enabling state public service commissions and the Federal Communications Commission to begin implementing many of the local competition provisions of the Telecommunications Act of 1996. The Federal Communications Commission prescribed certain minimum points of interconnection necessary to permit competing carriers to choose the most efficient points at which to interconnect with the incumbent local exchange carriers' networks. The Federal Communications Commission also adopted a minimum list of unbundled network elements that incumbent local exchange carriers must make available to competitors upon request and a methodology for states to use

in establishing rates for interconnection and the purchase of unbundled network elements. The Federal Communications Commission also adopted a methodology for states to use when applying the Telecommunications Act's "avoided cost standard" for incumbent local exchange carriers to set the prices to be charged to resellers of their services.

The Federal Communications Commission has authority to establish national pricing rules for interconnection, unbundled elements and resale services. The Supreme Court also upheld the Federal Communications Commission's interpretation of the "pick and choose" provisions, which permit carriers to obtain favorable provisions in interconnection agreements. However, the Supreme Court overturned the Federal Communications Commission's rules regarding what network elements must be unbundled by the Regional Bell Operating Companies, and remanded to the

Federal Communications Commission the question of what network elements are "necessary" to competing carriers such as the Company. On November 5, 1999, the Federal Communications Commission issued an order and proposed rulemaking establishing the network elements that must be offered by incumbent local exchange carriers as unbundled network elements. In addition, the Supreme Court's decision creates some uncertainty regarding the legal status of complaints filed at the Federal Communications Commission to enforce interconnection agreements. We cannot assure you that we will be able to maintain interconnection agreements on terms acceptable to us.

On December 9, 1999, the Federal Communications Commission released an order requiring incumbent local exchange carriers to offer "line sharing" arrangements that will permit competitors like us to offer DSL service over the same copper wires used by the incumbent local exchange carriers to provide voice service. The specific prices and terms of these arrangements will be determined by future decisions of state utility commissions, and cannot be predicted at this time. The Federal Communications Commission's ruling may also be challenged in court. We expect, however, that this order, if implemented, will allow us to offer DSL services at a significantly lower cost than is now possible. On March 17, 2000, the U.S. Court of Appeals for the District of Columbia Circuit vacated certain Federal Communications Commission rules relating to collocation of competitors' equipment in incumbent local exchange carriers' central offices. This decision requires the Federal Communications Commission to limit collocation to equipment that is "necessary" for interconnection with the incumbent local exchange carrier or access to the incumbent local exchange carrier's unbundled network elements. We believe that all of the equipment we currently place in collocation arrangements is necessary for these purposes, and therefore our collocation arrangements should not be adversely affected by the court decision. However, any disputes over the "necessary" status of particular items of equipment may have to be resolved by the Federal Communications Commission or by state commissions, and such disputes could result in delays or changes to our collocation plans.

Other Regulation. In general, the Federal Communications Commission's policies encourage the entry of new competitors in the telecommunications industry and are designed to prevent anti-competitive practices. Currently, large incumbent local exchange carriers such as GTE and the Regional Bell Operating Companies are regulated as "dominant" carriers, while competitive local exchange carriers such as the Company are considered "nondominant" carriers. Dominant carriers face more detailed regulatory scrutiny. As a nondominant carrier, we are subject to relatively minimal Federal Communications Commission regulation.

- Tariff. We may install and operate facilities for the transmission of domestic interstate communications without prior Federal Communications Commission authorization. The Federal Communications Commission requires us to file tariffs and periodic reports concerning our interstate circuits and deployment of network facilities, and offer interstate services on a nondiscriminatory basis, at just and reasonable rates. We also remain subject to Federal Communications Commission complaint procedures.

The Federal Communications Commission adopted an order in 1996 (the "Detariffing Order") which eliminated the requirement that nondominant interstate carriers maintain tariffs on file with the Federal Communications Commission for domestic interstate services. The order provided that, after a nine-month transition period, relationships between interstate carriers and their customers would be set by contract. Several parties requested reconsideration and/or filed appeals of the Detariffing Order. On February 13, 1997, the United States Court of Appeals for the District of Columbia Circuit stayed implementation of the Detariffing Order. If the Detariffing Order becomes effective, nondominant interstate services providers will no longer be able to rely on the filing of tariffs with the Federal Communications Commission as a means of providing notice to customers of prices, terms and conditions under which they offer their interstate services. If we cancel our Federal Communications Commission tariffs as a result of the Detariffing Order, we will need to individually negotiate contract terms with certain of our customers, which could result in substantial legal and administrative expense.

- Access Charges. The Federal Communications Commission has granted incumbent local exchange carriers significant flexibility in pricing their interstate special and switched access services on

a specific central office by central office basis. Under this pricing scheme, incumbent local exchange carriers may establish pricing zones based on access traffic density and charge different prices for each zone. We anticipate that this pricing flexibility will result in incumbent local exchange carriers lowering their prices in high traffic density areas, which is where our customers are concentrated. The Federal Communications Commission adopted an order on August 5, 1999 granting incumbent local exchange carriers subject to price cap regulation additional pricing flexibility. These changes will reduce access charges and will shift charges currently based on minutes to flat-rate, monthly per line charges. As a result, the aggregate amount of access charges paid by long distance carriers to access providers in the United States may decrease.

The order provides certain immediate regulatory relief to incumbent local exchange carriers subject to price cap regulation and sets a framework of "triggers" to provide those companies with greater pricing flexibility to set interstate access rates as competition increases. The order also initiated a rulemaking to determine whether the Federal Communications Commission should regulate the access charges of competitive local exchange carriers. If this increased pricing flexibility is not effectively monitored by federal regulators, it could have a material adverse effect on our ability to price our interstate access services competitively. A May 16, 1999 order, which was upheld on appeal by the United States Court of Appeals for the Eighth Circuit, substantially increased the amounts that incumbent local exchange carriers subject to the Federal Communications Commission's price cap rules ("price cap local exchange carriers") recover through monthly flat-rate charges and substantially decreased the amounts that these local exchange carriers recover through traffic sensitive (per-minute) access charges. Several parties appealed the May 16th order.

These decisions are likely to have a significant impact on our operations, expenses, pricing and revenue.

Universal Service Reform. The Federal Communications Commission implemented the provisions of the Telecommunications Act of 1996 relating to the preservation and advancement of universal telephone service in 1997. The Federal Communications Commission's universal service principles provide that universal service support mechanisms and rules should not unfairly advantage or disadvantage one provider or technology over another. All telecommunications carriers providing interstate telecommunications services, including us, must

contribute to the universal service support fund. On October 8, 1999, the Federal Communications Commission released an order implementing changes to its universal service rules to comply with a recent decision of the Fifth Circuit Court of Appeals. Among other changes, the Federal Communications Commission revised its rules concerning assessment of carriers' intrastate and international revenues for universal service contribution. The Federal Communications Commission narrowed the scope of the contribution base, removing intrastate end-user telecommunications revenues from the assessment, consistent with the opinion of the Fifth Circuit Court of Appeals. The contribution factor for the first quarter of 2000 is 5.877% of interstate and international end-user telecommunications revenues.

State Regulation

We believe that most, if not all, states in which we operate or propose to operate require a certification or other authorization to offer intrastate and local services. Many of the states in which we operate or intend to operate are in the process of addressing issues relating to the regulation of competitive local exchange carriers. We are subject to state tariff filing requirements.

These certifications generally require a showing that the carrier has adequate financial, managerial and technical resources to offer the proposed services in a manner consistent with the public interest.

We have obtained state authority for the provision of our dedicated services and a full range of local switched services and long distance services. In most states, we are required to file tariffs setting forth the terms, conditions and prices for services that are classified as intrastate. We plan to obtain additional state authorities to accommodate our business and network expansion.

Some states also impose reporting, customer service, and quality requirements, as well as unbundling and universal service requirements. In addition, we are subject to the outcome of proceedings held by state utility commissions to determine state regulatory policies with respect to incumbent local exchange carrier and competitive local exchange carrier competition, geographic build-out, mandatory detariffing and other issues relevant to competitive local exchange carrier operations. Certain states have adopted state-specific universal service funding obligations.

In addition to obtaining state certifications, we must negotiate terms of interconnection with the incumbent local exchange carrier before we can begin providing switched services. Our executed agreements are subject to the approval of the state commissions. State commissions have approved our existing agreements. We anticipate state commission approval of our future interconnection agreements.

We believe that, as the degree of local competition increases, the states will offer the incumbent local exchange carriers increasing pricing flexibility. This flexibility may present the incumbent local exchange carriers with an opportunity to subsidize services that compete with our services with revenues generated from noncompetitive services, thereby allowing incumbent local exchange carriers to offer competitive services at prices below the cost of providing the service. We cannot predict the extent to which this may occur, but it could have a material adverse effect on our business.

We actively participate in various regulatory proceedings before the states, the outcome of which may establish policies that affect our competitive and/or economic position in the local and other telecommunications services markets.

We also may be subject to requirements in certain states to obtain prior approval for, or notify the state commission of, any transfers of control, sales of assets, corporate reorganizations, issuances of stock or debt instruments and related transactions.

Local Government Authorizations. We are required to obtain street use and construction permits and licenses and/or franchises to install and expand our

fiber optic networks using municipal rights of way. In some municipalities where we have installed or anticipate constructing networks, we will be required to pay license or franchise fees based on a percentage of gross revenues or on a per foot basis, as well as post performance bonds or letters of credit. We are actively pursuing permits, franchises and other relevant authorities for use of rights-of-way and utility facilities in a number of cities.

FRANCHISES AND PERMITS

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically the subject of non-exclusive agreements of finite duration providing for the payment of fees or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are typically provided under non-exclusive multi-year agreements, which generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996 requires most utilities to afford access to rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates. However, there can be no assurance that delays and disputes will not occur. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence) of the other party.

CUSTOMERS

No single customer accounted for more than 10% of our consolidated revenues in 1998 or 1999. Our five largest customers accounted for 11% of our consolidated revenues in 1998 and 8% of our consolidated revenues in 1999. We expect customer concentration to continue to decrease as we expand into additional markets and increase full scale marketing of an integrated service package. In the near term, however, the loss of, or decrease of business from, one or more of our principal customers could have a material adverse effect on our business, financial condition and results of operations.

Although they are not our customers, we did recognize revenue of approximately $9.7 million, or 15.1% of our 1999 revenue, from incumbent local exchange carriers primarily related to reciprocal compensation for terminating local calls from customers of the incumbent local exchange carriers to Internet service providers which are our customers. Of this amount approximately 64% is attributable to reciprocal compensation due to us from BellSouth. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview - Revenue" for a discussion of a dispute which has arisen between incumbent local exchange carriers, such as BellSouth, and competitive

local exchange carriers, like us, with respect to the obligation of incumbent local exchange carriers to make reciprocal compensation payments to competitive local exchange carriers with respect to the termination of local calls to Internet service providers.

EMPLOYEES

As of February 29, 2000, we had approximately 1,100 full time employees. None of our employees are represented by a labor union or subject to a collective bargaining agreement, nor have we experienced any work stoppage due to labor disputes. We believe that our relations with our employees are good.

GEOGRAPHIC AREAS

We have no foreign operations. All of our networks are located in, and all of our revenues are attributable to, the United States.

ITEM 2. PROPERTIES.

We are headquartered in Bedminster, New Jersey in approximately 14,000 square feet of office space, approximately 7,200 of which we lease from Kamine

Development Corp. (an entity controlled by Mr. Kamine, the Company's Chairman of the Board). The lease with Kamine Development Corp., which expires in January 2007, provides for a base annual rental of approximately $217,000 (adjusted periodically for changes in the consumer price index), plus operating expenses.

We also maintain an operations center in an aggregate of approximately 104,000 square feet of leased space in Duluth, Georgia under leases which expire at various dates from July 2000 through February 2003. We also own or lease facilities in each of our existing markets for central offices, sales offices and the location of our switches and related equipment.

We believe that our facilities are in good condition, are suitable for our operations and that, if needed, suitable alternative space would be readily available.

ITEM 3. LEGAL PROCEEDINGS.

We are from time to time involved in litigation incidental to the conduct of our business. There is no pending legal proceeding to which we are a party, however, which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition and results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of security holders during the fourth quarter of 1999.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

There is currently no established trading market for our Common Stock, $0.01 par value per share. As of March 29, 2000 there were nine holders of record of our Common Stock.

We have never declared nor paid cash dividends on our Common Stock and do not presently anticipate paying any cash dividends on our Common Stock in the foreseeable future. We currently expect that earnings, if any, will be retained for growth and development of our business.

As a holding company, we depend upon the receipt of dividends and other cash payments from our operating subsidiaries in order to meet our cash requirements. Pursuant to the terms of our Amended and Restated Loan and Security Agreement, dated as of February 15, 2000, among our principal operating subsidiaries and a group of lenders led by First Union National Bank, Newcourt Commercial Finance Corporation and Lucent (the "Amended Senior Secured Credit Facility"), those subsidiaries are restricted in their ability to pay dividends on their capital stock. The indentures applicable to our 13 1/2% Senior Notes due 2009 and our 12 1/2% Senior Discount Notes due 2008, respectively, impose certain restrictions upon our ability to pay dividends on our capital stock.

Subject to the foregoing and to any restrictions which may be contained in any future indebtedness which we may incur, the payment of cash dividends on our Common Stock will be within the sole discretion of our Board of Directors, and will depend upon the earnings, capital requirements and financial position of the Company, applicable requirements of law, general economic conditions and other factors considered relevant by our Board of Directors.

On May 24, 1999, we sold $275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009 to Morgan Stanley & Co. Incorporated, as representative of certain initial purchasers. The sale of the Senior Notes to the initial purchasers was made in reliance upon the exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Section 4(2) of that Act, on the basis that the transaction did not involve a public offering. The initial purchasers agreed that any resales which they made would be made only (i) to qualified institutional buyers as defined in Rule 144A under the Securities Act, (ii) to institutional accredited investors as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act, or (iii) outside

the United States to persons other than U.S. persons in reliance upon Regulation S under the Securities Act.

On December 16, 1999, one institutional investor exercised 50 warrants to purchase an aggregate of 10 shares of our Common Stock for aggregate gross proceeds of $0.10. The issuance of the shares upon exercise of the warrants was made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, on the basis that the transaction did not involve a public offering. The Warrant Agreement applicable to the warrants contains representations as to such investor's investment intent and imposes substantial restrictions upon transfer of the securities.

On January 1, 1999, July 1, 1999 and October 1, 1999, the Company granted options to purchase an aggregate of 82,342 shares of its Common Stock to employees of the Company and employees of certain affiliates of the Company under the 1998 Stock Purchase and Option Plan for Key Employees of KMC Telecom Holdings, Inc. and Affiliates. No consideration was received by us for the issuance of the options. The options have various exercise prices with 67,509 exercisable at an exercise price of $125 per share, 2,933 exercisable at an exercise price of $225 per share, and 11,900 exercisable at an exercise price of $250 per share. The issuance of the options was made in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of that Act, on the basis that the transaction did not involve a public offering.

ITEM 6. SELECTED FINANCIAL DATA.

The selected financial data set forth below for the years ended December 31, 1995, 1996, 1997, 1998 and 1999 were derived from our audited financial statements and those of our predecessors. The data presented below should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and notes thereto included in "Item 8. Financial Statements and Supplementary Data."

	YEAR ENDING DECEMBER 31				
	1995	1996	1997	1998	1999
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)				
STATEMENT OF OPERATIONS DATA:					
Revenue	$ -	$ 205	$ 3,417	$ 22,425	$64,313
Operating expenses:					
Network operating costs	-	1,361	7,735	37,336	110,309
Selling, general and administrative	1,591	2,216	9,923	24,534	55,803
Stock option compensation expense	-	240	13,870	7,080	29,833
Depreciation and amortization	6	287	2,506	9,257	29,077
Total operating expenses	1,597	4,104	34,034	78,207	225,022
Loss from operations	(1,597)	(3,899)	(30,617)	(55,782)	(160,709)
Other expense (a)	-	-	-	-	(4,297)
Interest income	-	-	513	8,818	8,701
Interest expense (b)	(23)	(596)	(2,582)	(29,789)	(69,411)
Net loss	(1,620)	(4,495)	(32,686)	(76,753)	(225,716)
Dividends and accretion on redeemable preferred stock	-	-	(8,904)	(18,285)	(81,633)
Net loss applicable to common shareholders	$(1,620)	$ (4,495)	$ (41,590)	$ (95,038)	$(307,349)
Net loss per common share	$ (2.70)	$ (7.49)	$ (64.93)	$ (114.42)	$ (360.88)
Weighted average number of common shares outstanding	600	600	641	831	852
OTHER DATA:					
Capital expenditures (including acquisitions)	$ 3,498	$ 9,111	$ 61,146	$ 161,803	$ 440,733
Adjusted EBITDA(c)	(1,591)	(3,373)	(14,241)	(39,445)	(101,799)
EBITDA(c)	(1,591)	(3,613)	(28,111)	(46,525)	(135,929)
Cash used in operating activities	(779)	(2,687)	(8,676)	(33,573)	(98,293)
Cash used in investing activities	(1,920)	(10,174)	(62,992)	(180,198)	(277,078)
Cash provided in financing activities	2,728	14,314	85,734	219,399	440,156

	AS OF DECEMBER 31,				
	1995	1996	1997	1998	1999
BALANCE SHEET DATA:					
Cash and cash equivalents	$ 34	$ 1,487	$ 15,553	$ 21,181	$85,966
Investments held for future capital expenditures	-	-	-	27,920	-
Restricted investments(d)	-	-	-	-	89,571
Networks and equipment, net	3,496	12,347	71,371	224,890	639,324
Total assets	3,704	16,715	95,943	311,310	886,040
Long-term debt	2,727	12,330	61,277	309,225	811,137
Redeemable preferred stock	-	-	35,925	52,033	203,790
Redeemable common stock and warrants	-	-	11,726	22,979	46,680
Total nonredeemable equity (deficiency)	(1,623)	389	(26,673)	(104,353)	(384,4130)

(a) During the second quarter of 1999, the Company recorded a $4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

(b) Excludes capitalized interest of (i) $37,000 for 1995, (ii) $103,000 for 1996, (iii) $854,000 for 1997, (iv) $5.1 million for 1998 and (v) $6.6 million for 1999. During the construction of the Company's networks, the interest costs related to construction expenditures are capitalized.

(c) Adjusted EBITDA consists of earnings (loss) before net interest, income taxes, depreciation and amortization charges, stock option compensation expense (a non-cash charge) and other expense. EBITDA consists of earnings (loss) before all of the foregoing items except stock option compensation expense and other expense. These items are provided because they are measures commonly used in the telecommunications industry. They are presented to enhance an understanding of the Company's operating results and they are not intended to represent cash flow or results of operations in accordance with generally accepted accounting principles. Adjusted EBITDA and EBITDA are not calculated under generally accepted accounting principles and are not necessarily comparable to similarly titled measures of other companies. For a presentation of cash flows calculated under generally accepted accounting principles, see the Company's historical financial statements contained in Item 8 of this Report.

(d) Represents amounts pledged to secure the next five payments of interest on the 13 1/2% Senior Notes.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion and analysis together with the Company's financial statements, including the notes and the other financial information appearing elsewhere in this Report. Due to our limited operating history, startup nature and rapid growth, period-to-period comparisons of financial data are not necessarily indicative, and you should not rely upon them as an indicator of our future performance. The following discussion includes forward-looking statements.

OVERVIEW

General. We are a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III markets. The markets in which we operate are predominantly located in the Southeastern and Midwestern United States. We target as customers business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless service providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, Internet access infrastructure, ISDN, long distance, special

access, private line and a variety of other advanced services and features.

We have invested significant capital and effort in developing our telecommunications business. This capital has been invested in the development of our networks, the development and installation of operating systems, the introduction of services, marketing and sales efforts, and an acquisition. We expect to make significant additional capital expenditures to build additional networks, to expand current networks to additional customer buildings, long distance carrier points of presence and incumbent local exchange carrier central offices, and to broaden our service offerings, and we may consummate acquisitions. Proper management of our growth will require us to maintain cost controls, continue to assess market potential, ensure quality control in implementing our services, as well as to expand our internal management, customer care and billing and information systems, all of which will require substantial investment.

The development, construction and expansion of our networks requires significant capital, a large portion of which is invested before any revenue is generated. We have incurred, and expect to continue to incur, significant and increasing operating losses, negative adjusted EBITDA and net cash outflows for operating and investing activities while we expand our network operations and build our customer base. Based on our experience to date and that of our competitors, we estimate that a new network will begin to generate positive EBITDA within 24 to 36 months after commencement of commercial operations. Construction periods and operating results will vary from network to network. There can be no assurance that we will be able to establish a sufficient revenue-generating customer base or gross margins in any particular market or on a consolidated basis.

The facilities-based competitive local exchange carrier business is capital intensive. We estimate that the total initial costs associated with the purchase and installation of fiber optic cable and transmission and switching equipment, including capitalized engineering costs, will average approximately $10.0 million to $12.0 million for the fiber optic backbone and switch in each standard Tier III network, depending upon the size of the market served, the scope and complexity of the network, and the proportion of aerial to underground fiber deployment. Our actual costs could vary significantly from this range. The amounts and timing of these expenditures are subject to a variety of factors that may vary significantly with the geographic and demographic characteristics of each market. In addition to equipment and construction expenditure requirements, upon commencement of the construction phase of a network we begin to incur direct operating costs for such items as salaries and rent. As network construction progresses, we incur costs associated with construction, including

preparation of rights-of-way, and increased sales, marketing, operating and administrative expenses. We capitalize certain direct costs related to network planning and construction costs for new networks.

The initial construction of a network consists of deploying the fiber optic backbone, installing the switch and related electronics and testing the system. This takes approximately 6 months, depending upon the size and complexity of the network. The time required during the construction phase is also significantly influenced by the number of route miles involved, the mix of aerial versus underground fiber deployment, possible delays in preparing rights-of-way, provisioning fiber optic cable and electronic equipment, and required construction permits and other factors, including weather.

Local Services. To facilitate our entry into local services, we plan to install switching equipment in all of our markets. Switches are in commercial operation in all of our 34 operating markets and we expect to be in commercial operation in 3 additional Tier III markets by the end of the first half of 2000. We also intend to install Lucent switches in any future networks which we may build. Once a switch is commercially operational, we offer local dial tone and switched data services such as ISDN, Internet access infrastructure, Local Area Network-to-Local Area Network interconnect and Wide Area Network services, as well as voice mail and other custom calling features.